Date Mailed
January 31, 2003

BEFORE THE

PUBLIC SERVICE COMMISSION OF WISCONSIN

Accounting Treatment for Patronage Capital by Telecommunications Cooperatives — 05-US-115

FINAL DECISION

This is the final decision in the matter concerning the appropriate accounting treatment for patronage capital by incumbent local exchange carrier ("ILEC") telecommunications cooperatives,[1] including whether changes should be made to the Uniform System of Accounts ("USOA") for Class A and Class B telephone utilities.[2]

Introduction

Effective January 1, 1988, the Commission adopted a USOA in docket 05-US-102. (The Commission also implemented changes to the USOA, effective January 1, 2003, in docket 05-US-113.) Although telecommunications cooperatives, as well as other ILECs, are subject to the USOA, the USOA did not include any specifically-identified accounting treatment for cooperatives' patronage capital. While the Commission's Uniform System of Accounts for

[1] There are 11 cooperatives in Wisconsin: Chequamegon Telephone Cooperative, Inc.; Chibardun Telephone Cooperative, Inc.; Citizens Telephone Cooperative, Inc.; Cochrane Cooperative Telephone Company; LaValle Telephone Cooperative; Marquette-Adams Telephone Cooperative, Inc.; Nelson Telephone Cooperative; Richland-Grant Telephone Cooperative, Inc.; Tri-County Telephone Cooperative, Inc.; Vernon Telephone Cooperative, Inc.; and West Wisconsin Telcom Cooperative, Inc.

[2] A companion investigation, docket 05-US-113, *In the Matter of Prescribing a Uniform System of Accounts for Class A and Class B Telephone Utilities*, examined changes to the USOA effective January 1, 2003, to coincide with changes adopted by the Federal Communications Commission. At its open meeting on August 15, 2002, the Commission determined that the issue concerning accounting for cooperative's patronage capital should be addressed outside of docket 05-US-113; then-Chairperson Ave Bie dissented with respect to revisiting the patronage capital issue. On December 20, 2002, the Commission issued a Final Decision in docket 05-US-113; such decision did not reflect the impact of the Commission's decision for docket 05-US-115 in the prescribed USOA effective January 1, 2003.

Class C Telephone Utilities, effective January 1, 1975, included subaccounts for patronage capital within the retained earnings balance sheet category, this prescription was discontinued January 1, 1988, coincident with the Commission's adoption of a new USOA in docket 05-US-102.

Effective May 6, 1986, 1985 Wisconsin Act 297 enacted Wis. Stat. § 196.204, Cross-subsidization limited. Subsection (1) of Wis. Stat. § 196.204 states in part: "Except for retained earnings, a telecommunications utility may not subsidize, directly or indirectly, any activity, including any activity of an affiliate, which is not subject to this chapter or is subject to this chapter under s. 196.194, 196.195, 196.202 or 196.203." The Commission examined the meaning of the "except for retained earnings" language in docket 1090-TI-100 pertaining to Chibardun Telephone Cooperative, Inc. ("Chibardun"). Marcus Cable Partners, L.L.C., ("Marcus") was a party in that proceeding. In its November 16, 2001, decision,[3] ("Chibardun Order") the Commission equated this statutory phrase to the balance in account 4550, Retained Earnings, as set forth in the USOA. In addition, the Commission determined that Chibardun's patronage capital did not qualify for inclusion in account 4550, but rather it should be reclassified to account 4520, Additional Paid-in Capital, focusing on the "for capital" language in Chibardun's bylaws and the distributed nature of the patronage capital.

As a follow-up to the Chibardun Order, Commission staff issued a letter on December 17, 2001, to the 11 telecommunications cooperatives in the state (including Chibardun) requesting that each cooperative reclassify its patronage capital to account 4520, consistent with the

[3] *Investigation of Possible Improper Subsidization by Chibardun Telephone Cooperative, Inc., of its Subsidiaries and of Possible Related Violations*, Docket 1090-TI-100 (November 16, 2001), *aff'd sub nom. Marcus Cable Partners, L.L.C. v. Pub. Serv. Comm'n*, Case Nos. 01-CV-3244 & 01-CV-3455 (Wis. Dane Cty. Cir. Ct.) (January 7, 2003).

Chibardun decision, by December 31, 2001, or, in the alternative, inform the Commission of the particulars constituting alternate classification. On April 3, 2002, the last of the 11 responses were received from the cooperatives, all of whom requested the establishment of two subaccounts in account 4550 pertaining to patronage capital (4550.1, Retained Earnings-Patronage Capital Unassigned, and 4550.2, Retained Earnings-Patronage Capital Assigned) and a new account 4511, Members Equity, with an effective date of December 31, 1988. In its 2001 annual report filed with the Commission, Chibardun reclassified its patronage capital to account 4520. Commission staff requested and examined the bylaws of the 11 cooperatives, noting that Chibardun and Nelson Telephone Cooperative's ("Nelson") bylaws contained an additional provision pertaining to nonregulated or nonoperating income.

The Commission issued a Notice of Investigation on August 26, 2002, requesting initial comments by October 1, 2002, and reply comments by October 11, 2002, concerning the following list to facilitate resolution of this matter.

1. Whether the Commission's patronage capital accounting directives as it concerns accounts 4520, Additional Paid-in Capital, and 4550, Retained Earnings, and its interaction with Wis. Stat. § 196.204 addressed in the Chibardun Order should be extended to all ILEC telecommunications cooperatives, or a portion thereof. If not, whether the Commission's Chibardun Order concerning patronage capital accounting should be rescinded.

2. Whether the language in the respective ILEC telecommunications cooperative's bylaws influence in any way and, if so, to what extent, the accounting treatment to be accorded to patronage capital.

3. In what respects similarities between ILEC telecommunications cooperatives and for-profit ILECs should influence, if at all, the accounting treatment to be accorded to patronage capital.

4. What relevance Wis. Stat. ch. 185 should play in the accounting treatment to be accorded to patronage capital.

5. Whether the treatment or consideration accorded to patronage capital by other governmental agencies (e.g., RUS), via legal requirements (including court cases or other directives) or external lenders influence in any way and, if so, to what extent, the accounting treatment to be accorded to patronage capital.

6. Whether the Commission's accounting treatment of patronage capital has any impact, whatsoever, on the ILEC telecommunications cooperatives' nontaxable status for either federal or state income tax purposes.

7. Whether the Commission should adopt two new subaccounts 4550.1, Retained Earnings-Patronage Capital Unassigned, and 4550.2, Retained Earnings-Patronage Capital Assigned, and create a new account 4511, Members Equity.

8. If patronage capital-related amendments to the USOA are adopted, what should be the effective date of any such changes. If not adopted prospectively, whether any particular past date(s) should be utilized.

9. Any other comments applicable to this matter.

Initial comments were filed by the Wisconsin State Telephone Cooperative Association ("WSTCA") and the Wisconsin Federation of Cooperatives ("WFC"); Wisconsin State Telecommunications Association ("WSTA")--Small Company Committee ("WSTA-SCC"), representing a subset of WSTA; University of Wisconsin ("UW") Center for Cooperatives ("UW-CC"); Rural Utilities Service ("RUS"), a division of the United States Department of Agriculture and a lender to many ILECs in the state; Rural Telephone Finance Cooperative ("RTFC"), also a lender to cooperatives in Wisconsin; Wisconsin Cable Communications Association ("WCCA"), of which Marcus is a member; and CenturyTel, Inc. ("CenturyTel"), owner of 12 ILECs in Wisconsin, one of which was affected by competitive inroads made by Chibardun. Reply comments were filed by WSTCA and WFC, WCCA, CenturyTel, and

Verizon North Inc. ("Verizon"), also an ILEC in the state. (Commenters are listed in Appendix A.)

Although the docket title contains the phrase "accounting treatment for patronage capital," it essentially deals with the treatment of patronage capital under the "except for retained earnings" language in Wis. Stat. § 196.204(1). The cooperatives claimed that if the Commission requires the cooperatives to classify their patronage capital in account 4520, Additional Paid-in Capital (rather than account 4550, Retained Earnings), it will result in dire consequences for the cooperatives (e.g., possible loss of cooperative and/or tax-exempt status, lack of monies for investment for regulated and nonregulated services, trouble with external lenders) and represents a departure from longstanding accounting and policy treatment. The 11 cooperatives also posited that several other commenters support their position, including WSTCA and WFC, WSTA-SCC, UW-CC, RUS, and RTFC.

Commenters supporting accounting treatment in account 4520 (in effect, limiting the extent to which cooperatives may cross-subsidize under Wis. Stat. § 196.204(1)) included WCCA, CenturyTel, and Verizon. They do not object to cooperatives providing regulated services to their franchise customers, but they urged the Commission to reject the cooperatives' argument that they should be allowed to use their tax-exempt status to unfairly compete in the provision of nonregulated services outside of their franchise territories. They pointed out that the entirety of the WSTA membership does not support the cooperatives' position on this matter.

At its open meeting on November 26, 2002, the Commission discussed the various issues surrounding the appropriate accounting treatment for cooperatives' patronage capital. Based on the record in this docket, the Commission determines that a cooperative's patronage capital should be classified in account 4540, Other Capital. In rendering its decision concerning this matter, the Commission is cognizant of the many differences between cooperatives and for-profit ILECs, but also the inherent conflict between the cooperatives' obligations to repay patronage capital to their patrons and the potential risk to such patronage capital if cooperatives are allowed to utilize patronage capital to finance competitive ventures. The Commission also recognizes its associated obligation to enforce the provisions of Wis. Stat. § 196.204(1) for all ILECs, including cooperatives. The Commission also determines, based on the record, that account 4540 is the appropriate account for classification of membership fees, if any, collected by a cooperative.

Findings of Fact

The Commission reviewed the filed comments pertaining to the nine items set forth in the Notice, and, based on such review, herein determines the following:

1. The account 4520 patronage capital accounting directive set forth in the Chibardun Order should not be extended to all ILEC telecommunications cooperatives, but rather should be modified to classification in account 4540 for all cooperatives.

2. The language in the cooperatives' bylaws and associated comments filed in this docket document the dual nature of patronage capital as both capital stock and retained earnings, thus supporting an accounting classification in an account other than accounts 4520 or 4550.

3. Telecommunications cooperatives differ from for-profit ILECs concerning profit motive, taxability, and the existence of retained earnings.

4. Wis. Stat. ch. 185 is not relevant to the determination of the appropriate accounting classification of patronage capital.

5. Treatment or consideration accorded to patronage capital by other governmental agencies, via legal requirements, or external lenders is relevant to the determination of the appropriate accounting classification of patronage capital, warranting a change in the appropriate account classification from account 4520 to 4540.

6. Classification of telecommunications cooperatives' patronage capital in account 4540, Other Capital, will not impact the cooperatives' nontaxable status for either federal or state income taxes.

7. It is reasonable to not adopt subaccounts 4550.1 or 4550.2 or account 4511, as proposed by the cooperatives. It is reasonable to require all telecommunications cooperatives to classify patronage capital and membership fees in account 4540, Other Capital. Such amounts are not available for permissible cross-subsidization pursuant to Wis. Stat. § 196.204(1).

8. It is reasonable to modify account 4540 of the USOA, effective as of January 1, 2003. An earlier implementation date is not warranted based on a review of the comments filed in this docket.

On December 20, 2002, the Commission released its Final Decision in docket 05-US-113, adopting a new USOA, effective January 1, 2003. The Final Decision did not reflect the outcome of the Commission's deliberation in docket 05-US-115. A further amendment, effective January 1, 2003, to account 4540 of the USOA, identified via redline and strikeout, is set forth in Appendix B. As with the Final Decision in docket 05-US-113, any revision or amendments as made or adopted by the Federal Communications Commission ("FCC") subsequent to the issue date of this order shall not be effective for Wisconsin jurisdictional purposes without order by this Commission.

Conclusions of Law

1. The Commission has jurisdiction under Wis. Stat. §§ 196.02, 196.06, 196.204, and other provisions of Wis. Stat. ch. 196 as may be pertinent hereto, to prescribe and amend uniform accounting systems for those utilities subject to its jurisdiction.

2. Patronage capital does not constitute retained earnings as used in Wis. Stat. § 196.204(1).

Opinion

In this docket, the cooperatives requested that the Commission reverse that portion of the Chibardun Order as it pertains to classification of patronage capital in account 4520, Additional Paid-in Capital (rather than in account 4550, Retained Earnings), and the associated nonavailability of patronage capital for permissible cross-subsidization under the "except for retained earnings" language in Wis. Stat. § 196.204(1), based on its classification in an account other than 4550. The cooperatives also requested establishment of a new account 4511, Members Equity, for membership fees collected by cooperatives.

In the Chibardun Order, the Commission stated that the language in Chibardun's bylaws warranted classification of patronage capital in account 4520, because, in effect, it has been distributed, in contrast to the "undistributed balance" language contained in the definition of account 4550 in the USOA. The Commission's review of the other ten cooperatives' bylaws shows virtually identical language as set forth in the Chibardun bylaws. At issue is certain language in cooperative bylaws establishing treatment of patronage capital: "all such amounts credited to the capital amount of any patron shall have the same status as though paid to the patron in cash in pursuance of a legal obligation to do so and the patron has then furnished the

Cooperative corresponding amounts for capital." The Commission is not persuaded that the bylaw language has a meaning completely different from the Commission's interpretation leading to classification other than in account 4550, Retained Earnings.

The Commission also notes that the bylaws of Chibardun and Nelson contain additional language establishing a separate retained earnings (or nonpatronage capital) classification. Such language states: "All other amounts received by the Cooperative from non-regulated or non-operating income … in excess of operating costs and expenses properly chargeable against the furnishing of such services … shall insofar as permitted by law: (1) Be reserved as unallocated retained earnings, and shall not be allocated to the Cooperative's patrons on a patronage basis … ." The establishment of this separate retained earnings classification within the bylaws lends further credence to a nonaccount 4550 classification for patronage capital.

Cooperatives are nonprofit entities owned and controlled by their users with benefits accruing to the users according to use or patronage. Cooperatives secure capital from equity capital through member investment, retained patronage refunds, or from the sale of stock. While a cooperative is governed by a board of directors, it is subject to requirements of other governmental agencies (e.g., RUS), state and federal statutes, and external lenders. Cooperatives, unlike for-profit, investor-owned "C" corporations, do not have retained earnings.

The Commission notes that although Wis. Stat. ch. 185 prescribes statutory obligations for cooperatives, and, in particular, Wis. Stat. § 185.45 prescribes procedures for cooperatives' apportionment and distribution of proceeds, such information is not relevant to determination of the appropriate accounting classification for cooperatives' patronage capital for Commission jurisdictional purposes.

Through its accounting directive concerning patronage capital, the Commission desires to avoid creation of a myriad of potential governance and income tax problems, identified by WSTCA and WFC, UW-CC, and others in filed comments. The Commission believes that classification of patronage capital in account 4520 may have heightened such concerns. However, it is definitely not a foregone conclusion that account 4550 is a more appropriate accounting classification, based on the Commission's review of the bylaw language and analysis of account language in the Commission-prescribed USOA.

This decision provides a superseding technical correction of that portion of the Chibardun Order pertaining to the appropriate classification of patronage capital. The UW-CC comments note that a cooperative's directors generally divide the margin between cash payments and a retained portion ("retained patronage refund" or "allocated equity") "to build up member's equity obligation to provide necessary operating capital." This "allocated equity" must be paid back to cooperative members, or "redeemed," over a reasonable period of time. This "temporary equity capital" method of cooperative financing is referred to as a "revolving fund." This contrasts with "un-allocated equity" or "permanent capital," which is not traceable to individual members and has no redemption obligation except upon cooperative dissolution. The comments further describe how the board of directors, in making decisions concerning investments based on capital needs of the cooperative, determines what portion of the patronage refund should be paid out in cash to cooperative members and what portion should be retained to build up members' equity obligations to provide necessary operating capital.

In its filed comments, the RUS raised concerns regarding possible conflicts in patronage capital accounting prescribed by this Commission and that set forth in accounting rules that RUS imposes on its borrowers. However, RUS also noted that "patronage capital … is a combination of capital stock and retained earnings." The Commission believes that, in fact, this represents the truest statement as to the real "economic" nature of cooperatives' patronage capital. RUS' statement also reconciles with UW-CC's interpretation of allocated equity as "temporary equity capital." These definitions support an accounting classification of patronage capital not to account 4520 or 4550, but rather to another equity account, such as 4540.

Cross-subsidization limitations specified in Wis. Stat. § 196.204(1) must be enforced by the Commission. This enforcement extends to all LECs, including cooperatives. Wis. Stat. § 196.204(1) states that "except for retained earnings," a telecommunications utility shall not subsidize. This language caps subsidization loss risk to past profits classified in retained earnings, thereby protecting the core utility capital structure. As noted above, patronage capital is neither pure retained earnings nor equity capital, but rather a combination of both. It should not be placed at risk of loss (or gain) based on current Wis. Stat. § 196.204(1) restrictions. To do otherwise would endanger the cooperative's core utility capital structure, inconsistent with the legislative intent expressed in Section 1 of 1985 Wisconsin Act 297, which stated, in part, that the Commission should keep "as its main purpose the protection of the interests of ratepayers of public utilities offering regulated telecommunications services" during a time of transition in the telecommunications industry.

The Commission acknowledges that its system of accounts for Class C telephone utilities effective from 1975 through 1987 did classify patronage capital in retained earnings. While this treatment was changed for unknown reasons, it would appear inappropriate to resurrect the pre-1988 account 4550 classification for patronage capital, especially given the new competitive environment in telecommunications, where proper protection of ratepayers from the effects of ILEC competitive ventures is an even more pressing concern than it was in the mid-1980's.

The Commission's review of the extensive comments contained in the record for this docket (as opposed to the more limited record developed in the Chibardun proceeding) leads to an accounting classification of patronage capital for Wisconsin jurisdictional purposes in an equity account other than account 4520, but not retained earnings. In the Chibardun proceeding, the Commission did not perform an in-depth examination of the repayable nature of patronage capital, which led to the cooperatives' concerns with their potential noncompliance with Internal Revenue Service ("IRS") requirements regarding excessive retention of funds, their proper duty to allocate net proceeds to their patrons under the cooperative bylaws, and external lenders' loan requirements. The Commission concludes that account 4540, Other Capital, is the appropriate accounting classification for all cooperatives' patronage capital. The Commission believes that this accounting classification avoids a potential IRS revenue recognition event that may have been associated with account 4520, and preserves the tax-exempt status of cooperatives in place prior to examination of this matter. This classification also avoids potential governance and external lender concerns associated with account 4520 classification of patronage capital. Account 4540 is also appropriate for classification of membership fees collected by cooperatives, similar to accounting prescribed to cooperatives by RUS for such activity.

These changes in accounting will coincide with the January 1, 2003, effective date of other changes to the USOA set forth in the Commission's order dated December 20, 2002, in docket 05-US-113. The Commission finds that an earlier implementation date, as requested by the cooperatives, is not warranted as the books for those years have been long closed.

Based on the accounting classification prescribed herein, neither patronage capital nor membership fees are available to cooperatives for permissible cross-subsidization under Wis. Stat. § 196.204(1). However, retained earnings realized through supplemental bylaw language (similar to that established by Chibardun and Nelson) are available for such purposes. Likewise, cooperatives' equity investments in subsidiaries are not subject to the Wis. Stat. § 196.204(1) limitation on cross subsidies. This accounting classification will not impact the cooperatives' provision of regulated services to their members in the franchise territories on a not-for-profit basis, but may impact the cooperatives' launch or expansion of competitive ventures outside of the franchise territory on other than an investment basis.

Order

1. The Uniform System of Accounts for Class A and Class B telephone utilities adopted by the Commission effective January 1, 2003, in docket 05-US-113, is further amended on same date as set forth in attached Appendix B. Any existing expiration of suspension, or revision or amendments, as made or adopted by the FCC subsequent to the issue date of this order, will not be effective for Wisconsin jurisdictional purposes without order by this Commission.

2. All telecommunications cooperatives, including Chibardun, shall reflect patronage capital and membership fees in account 4540, Other Capital, in annual reports filed with the Commission pursuant to Wis. Stat. § 196.07.

3. The Commission retains continuing jurisdiction over utility accounting systems.

Dated at Madison, Wisconsin, ______________________________________

By the Commission:

____

Lynda L. Dorr
Secretary to the Commission

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See attached Notice of Appeal Rights

<u>Notice of Appeal Rights</u>

Notice is hereby given that a person aggrieved by the foregoing decision has the right to file a petition for judicial review as provided in Wis. Stat. § 227.53. The petition must be filed within 30 days after the date of mailing of this decision. That date is shown on the first page. If there is no date on the first page, the date of mailing is shown immediately above the signature line. The Public Service Commission of Wisconsin must be named as respondent in the petition for judicial review.

Notice is further given that, if the foregoing decision is an order following a proceeding which is a contested case as defined in Wis. Stat. § 227.01(3), a person aggrieved by the order has the further right to file one petition for rehearing as provided in Wis. Stat. § 227.49. The petition must be filed within 20 days of the date of mailing of this decision.

If this decision is an order after rehearing, a person aggrieved who wishes to appeal must seek judicial review rather than rehearing. A second petition for rehearing is not an option.

This general notice is for the purpose of ensuring compliance with Wis. Stat. § 227.48(2), and does not constitute a conclusion or admission that any particular party or person is necessarily aggrieved or that any particular decision or order is final or judicially reviewable.

Revised 9/28/98

APPENDIX A

This docket is not a contested case under Wis. Stat. ch. 227. Therefore there are no parties to be listed or certified under Wis. Stat. § 227.47. However, an investigation was conducted, and the persons listed below participated.

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(Not a party but must be served)
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APPENDIX B

PART 32--UNIFORM SYSTEM OF ACCOUNTS FOR TELECOMMUNICATIONS COMPANIES, as adopted by this Commission is amended as follows (redline and strikeout functions utilized):

§ 32.**4540** Other capital.

This account shall include amounts which are credits arising from the donation by stockholders of the company's capital stock, capital recorded upon the reorganization or recapitalization of the company and temporary declines in the value of marketable securities held for investment purposes. (See also Account 1410, Other noncurrent assets).

This account shall also include a cooperative's patronage capital and membership fees collected by a cooperative.